No. 84-165

In The

Supreme Court of the United States

October Term, 1984

W. GEORGE GOULD,

Petitioner,

vs.

MAX A. RUEFENACHT, et al.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Did the Court of Appeals correctly hold that the purchase of fifty percent of the shares of stock of a closely held corporation by one who participates in the affairs of the corporation is the purchase of "securities" within the meaning of the federal securities laws?

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STATEMENT OF THE CASE

In the summer of 1980 plaintiff-respondent, Max A. Ruefenacht (Ruefenacht), purchased fifty percent of the issued and outstanding shares of common stock of Continental Import and Export, Inc. (Continental) an importer and distributor of wines and spirits.

The other fifty percent was held by defendant, Joachim Birkle (Birkle), Birkle's wife and a corporation known

as Lenzenhof GmbH whose affairs were controlled by Birkle. An an incentive to entice Ruefenacht to purchase the shares, certain financial statements, prospectuses and pro forma balance sheets were given to him. Ruefenacht contends that the representations as to Continental's financial status contained in those documents contained material misrepresentations of fact and omitted to state material facts necessary to make the facts contained therein not misleading. Ruefenacht contends that he purchased the shares in reliance upon the misrepresentations and with ignorance of the omissions.

Although Ruefenacht did perform certain limited services on behalf of Continental, he never intended to and, in fact, never did participate in the daily management of its business affairs. On the contrary, at all times, Ruefenacht was a full time employee of another corporation in a different line of business. Ruefenacht never attempted or intended to exercise any control over the day-to-day affairs of Continental nor could he. The only control which he maintained was that degree of control to which any fifty percent shareholder would be entitled by law.

After he had paid $120,000 on account of the $250,000 purchase price Ruefenacht learned of the false nature of the representations made and the omissions and sought to rescind the transaction and obtain return of his money which request was refused. Upon that refusal, Ruefenacht instituted this action against Birkle, Continental, Christopher O'Halloran, the certified public accountant who prepared the financial statements and W. George Gould, the petitioner herein (Gould). Gould was both

Continental's corporate counsel and a member of its Board of Directors in which capacity he both approved and prepared the directors' resolutions containing the allegedly false financial data which he then submitted to O'Halloran. Ruefenacht alleged violations of Sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. § 77(1) (2), Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), Rule 10(b) (5) of the Securities and Exchange Commission, 17 C.F.R. 240.10(b) (5) as well as certain state law claims.

Gould moved for summary judgment seeking to dismiss the federal securities law claims on the grounds that the shares of stock purchased by Ruefenacht were not "securities" within the definition of the federal securities laws. The motion further sought to dismiss the pendent state law claims based upon lack of federal jurisdiction. Relying on the theory of law known as the "Sale of Business doctrine"* Gould contended that Rue-

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*The concept of the "sale of business doctrine" has been adopted by several circuits. One of the less attractive aspects of that doctrine seems to be that the precise definition tends to vary from court to court. More or less, it seems to provide that where one acquires control (the nature of which is never clear) over a corporation through the purchase of all or substantially all of its stock, (how much is subject to debate) the purchaser (as opposed to the Seller?) should not be entitled to the protection of the federal securities laws because the acquisition of the stock is merely a means to purchase the business itself. See, *Landreth Timber Co. v. Landreth,* [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,705 at 97,827 (9th Cir. March 7, 1984), *petition for cert. filed,* 52 U.S.L.W. 3908 (U.S. May 31, 1984) (No. 83-1961); *Christy v. Cambron,* 710 F.2d 669, 672 (10th Cir. 1983); *Sutter v. Groen,* 687 F.2d 197, 199-204 (7th Cir. 1982); *King v. Winkler,* 673 F.2d 342, 344-46 (11th Cir. 1982).

fenacht participated in the company's affairs to such an extent and acquired such significant control over Continental's business that his stock purchase was not an investment made with the expectation that profits would come solely from the efforts of others.

After an evidentiary hearing on the issue of the extent to which Ruefenacht intended to acquire control over Continental, the trial court concluded:

> "The trend of the law is to apply the 'economic reality' test to purchases of less than all of the company's stock to determine whether the purchaser would actively manage his investment. Because Mr. Ruefenacht intended to jointly manage Continental with Mr. Birkle, he did not purchase 'securities' as defined in the federal acts."

Ruefenacht v. O'Halloran, et al., No. 80-4097 (D. N.J. April 15, 1983).*

On the strength of that conclusion the trial court granted summary judgment dismissing the securities law claims. In its discretion the court dismissed the pendent state law claims as well.

On Ruefenacht's appeal, the Third Circuit reversed, holding that it is neither necessary nor appropriate for the court to examine the economic realities of the purchase or sale of all or part of the business effectuated by the transfer of stock bearing the traditional incidents of stock ownership concluding that:

> "The sale of all or part of the business effectuated by the transfer of stock bearing the traditional incidents of stock ownership is the sale of a 'security' under the 1933 and 1934 Acts."

Ruefenacht v. O'Halloran, 737 F.2d 320 (3d Cir. 1984).

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*Unreported but reproduced in Appendix B of the Petition for Writ of *Certiorari* filed herein at p. 44a.

ARGUMENT

POINT I

There Is No Case Presently Pending Before This Court Which Will Permit The Court, In Conjunction With This Case To Delimit The Definition Of "Security" Under Federal Law As Suggested By Petitioner.

Petitioner has suggested that because of the grant of *certiorari* in *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982), *modified*, 710 F.2d 95 (1983), *cert. granted*, 52 U.S.L.W. 3185 (1984) *(Seagrave)* this Court should grant *certiorari* in this matter to add "two important factual dimensions not present in *Seagrave*." In thus attempting to bootstrap himself into the Supreme Court, petitioner suggests that he should be here by virtue of the pendency of *Seagrave*. Since the filing of Mr. Gould's Petition, however, *Seagrave* has been dismissed and is no longer pending before this Court. Accordingly, there is nothing to which to append the instant case.

Respondent is aware, however, that a Petition for a Writ of *Certiorari* has been filed in *Landreth Timber Co. v. Landreth*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,705 (9th Cir. March 7, 1984), *petition for cert. filed*, 52 U.S.L.W. 3908 (U.S. May 31, 1984) (No. 83-1961) *(Landreth)*. While not conceding that a grant of *certiorari* would be appropriate in *Landreth*, if the Court were to grant *certiorari* to petitioner in *Landreth* two important considerations impel Mr. Ruefenacht to suggest that a grant of *certiorri* also would be appropriate here.

Preliminarily, respondent wishes to be clear in his position that the sale of business doctrine is entirely base-

less and has no place in the federal securities laws. Nonetheless, if the Supreme Court considers the issue of the sale of business doctrine important enough to review, the *Ruefenacht* action does provide a vehicle for the Court to decide whether that doctrine should exist at all and, if so, to provide guidance on its parameters. The instant case does provide a unique opportunity because it involves both a purchase of fifty percent of the outstanding shares (neither a majority nor a minority) and an individual who did participate, to some extent, in the affairs of the business, without devoting his entire strength, time and energy to it.

Further, a decision in *Landreth* acknowledging the existence of the sale of business doctrine without any decision in this case would leave Mr. Ruefenacht very much up in the air on how that doctrine would apply to him. The trial court here established its own view of what the sale of business doctrine is. One of the severest failings of that doctrine is that each court which has advanced it has done so in a different way and with different parameters. In the event that this Court should accept that doctrine it may or may not adhere to the trial court's ruling here that for the purchase of stock to be a security, the profits of the venture must be derived "solely" from the efforts of others.

Obviously, in the event that the Court were to reject the sale of the business doctrine, as Mr. Ruefenacht believes it must, there would be no reason to decide this case at all inasmuch as the rejection of the sale of business doctrine automatically would affirm the decision of the Third Circuit.

POINT II

The Third Circuit's Ruling Is In Absolute Conformity With The Holdings Of The Supreme Court In Forman And Weaver.

Petitioner argues that the *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837 (1975) requires that the Court apply the "economic reality test" (as they perceive it to have been applied in *Forman)* in each transaction where federal securities laws are invoked, in order to determine whether the instrument in question is, in fact, a "security". Petitioner contends that *Forman* rejected what he refers to as the "literal approach" to the definition of a security and that this Court established a rule which requires a court to evaluate the "economic realities" of each transaction alleged to involve a security in order to determine whether or not, within the context of that transaction, the plaintiff met the "economic reality" test first enunciated by this Court in *S.E.C. v. W. J. Howey Co.,* 328 U.S. 293 (1946) *(Howey).* Petitioner contends that this test must be applied whether or not the instrument was one of those specifically enumerated as a security in the statute such as "stock".

Petitioner contends further that the Third Circuit's ruling conflicts with his view of the holding in *Forman* and *Marine Bank v. Weaver,* 455 U.S. 551 (1982) *(Weaver).*

Indeed, the Third Circuit's opinion in *Ruefenacht* does conflict with petitioner's reading of both *Forman* and *Weaver;* the decision is in complete accordance with the decisions in *Forman* and *Weaver* themselves, however.

In *Forman* this Court determined that an instrument referred to as "stock" held by a tenant in a cooperative apartment building was not a security under the federal securities laws. The Court first examined the instrument to determine whether *in reality* that instrument was stock. It is this examination as to whether the instrument itself really was stock that seems to have confused petitioner. The Court observed:

> "We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called 'stock', must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock.' Rather we adhere to the basic principle that has guided all of the court's decisions in this area:
>
> "'[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality.' Tcherepnin v. Knight, 389 U.S. 332-336 (1967)." 421 U.S. at 848.

The reference to economic reality referred to in the first part of the *Forman* decision was simply a reference to the character of the instrument itself and not the nature of the transaction as petitioner mistakenly contends. The instruments held by the tenants, the court concluded, lacked the attributes commonly associated with stock: the right to participate in dividends, negotiability, capacity to serve as collateral, voting rights in proportion to the number of shares owned, and appreciation in value. Consequently, the court concluded, as a matter of economic reality the shares in issue were not "stock" within the meaning of the securities acts. *Forman* at 848.

This Court further noted that occasions may arise when the use of a particular name would lead a purchaser justifiably to assume that the federal securities laws would apply observing that:

> "[t]his would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument." *Forman* at 850-851.

Having determined that the instrument in question was not really "stock" and therefore not automatically a security, this Court went on to determine whether the instrument still might qualify as a security under another part of the definition, in that case, as an "investment contract". It was in order to determine whether or not the tenant's "shares" constituted an investment contract that the court applied the *Howey* test and concluded that they did not, *Forman* at 851-858. In the course of its investment contract analysis the Court observed:

> "In considering these [the investment contract] claims we must again examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties. We perceive no distinction, for the present purposes, between an 'investment contract' and an 'instrument commonly known as a "security".' In either case, the basic test for distinguishing the transaction from other commercial dealings is 'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.' *Howey,* 328 U.S. at 301." 421 U.S. at 851-852.

At no time did this Court suggest that the *Howey* test was to be applied to an instrument containing the attributes of traditional stock. Had this Court intended to do that it would have. Nor did this Court hold that the

same economic realities test applies to the definition of "stock" and "investment contract". To the contrary, in assessing the economic realities of a stock transaction the Court pierced the label to look to the underlying attributes of the instrument. In evaluating whether a transaction involved an investment contract it applied the *Howey* test.

Petitioner goes on to contend that the recent holding of this Court in *Weaver* supports their position and that the Third Circuit has misinterpreted *Weaver* as well. Once again, petitioner misreads the relevant authority. In holding that a certificate of deposit insured by the F.D.I.C. did not constitute a security, the Court reasoned, in part, that the F.D.I.C. has supplanted any necessity for coverage under the securities laws. 455 U.S. at 558. In doing so it adopted a theme expressed by it in *International Brotherhood of Teamsters v. Daniels,* 439 U.S. 551 (1981) where the court held that a noncontributory, compulsory pension plan was not an investment contract in part because ERISA supplanted any necessity for coverage by the securities acts 439 U.S. at 569-570.

Nor does the language of *Weaver* suggest that the *Howey* test should be applied to determine whether an instrument which falls within the strict definition of a security is in fact entitled to coverage under the federal securities laws. In *Weaver,* the plaintiffs had contended that the certificate of deposit was a "security" or, alternatively, that the private agreement between the plaintiffs and the borrowers was a "security". In arriving at its decision that no security was involved, this Court followed the same two step test that it enunciated in *Forman.* First,

it examined the statutory definition of a security and observed that while the term "certificate of deposit" was not found therein, there were other instruments to which the certificate of deposit might be equivalent. The Court observed, of course, that if the certificate of deposit was the equivalent of any of the specifically named instruments, it would automatically qualify as a security. 455 U.S. at 557-558. The Court found that it was not.

Having concluded that the certificate of deposit could not be equated with any of the specifically enumerated items which would automatically qualify it for treatment as a security, this Court applied the second part of the same two part test which it applied in *Forman* to determine whether the agreement between plaintiffs and the borrowers might be a "certificate of interest or participation in a profit sharing agreement" or an "investment contract". 455 U.S. at 559. Here, for the first time, the Court applied the *Howey* test and found, that based on that test, that the particular agreement did not fall within the definition of either an investment contract or a profit sharing agreement and accordingly could not qualify as a security under those definitions either. 455 U.S. 556-560. Accordingly, *Weaver* reinforces the position of the Third Circuit and not that taken by petitioner.

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CONCLUSION

For the foregoing reasons, respondent respectfully prays that unless the Court determines to grant *certiorari* in *Landreth* or some other case in which it will determine

the existence (or, preferably, lack thereof) of the sale of business doctrine, the Petition for a Writ of *Certiorari* should be denied for the reasons expressed above; in the event *certiorari* is granted in Landreth or some other case involving the same issue, respondent concedes that a grant *certiorari* would be appropriate in this case.

Respectfully submitted,

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